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ICPS upgrades its forecast for Ukraine's economy

ICPS economists predict that real GDP will continue to grow at a fast pace in Ukraine, reaching 10% in 2004. The key factor behind this economic growth is high demand for Ukrainian export commodities. However, an expected slight deterioration in the situation on world markets will gradually lead to slower rates of economic growth: 8% in 2005 and 7% in 2006. For more information about ICPS's upgraded economic forecast and an analysis of economic processes, read the next issue of Quarterly Predictions

Euphoria hurts reforms

The economic growth that started in 2000 in Ukraine continues to steam ahead. According to preliminary calculations from DerzhKomStat, the state statistics committee, real GDP growth jumped to a record-high 9.4% in 2003 and hit 10.8% over Q1 of 2004. In the last while, construction, refining and retail trade have grown the fastest. The economic boom has been accompanied by record-high growth in indicators for: (1) bank lending portfolios (61% in 2003 vs 47% in 2002); (2) net influx of FDI (US $1.4 bn in 2003 vs US $0.7 bn in 2002); (3) goods and services exports (24% vs 11%); and (4) retail turnover (19.4% vs 14.8%).

Such record-high growth figures have led to a certain euphoria, which is not conducive to serious reforms—especially in the public sector. ICPS expects that the reform process will be largely on hold through 2004, and that the Government will be putting most of its efforts into the election campaign. Yet the conditions for instituting economic reforms will remain favorable: despite a slight deterioration in the situation on world commodity markets in 2005–6, real GDP growth rates will remain high.
A moderate slowdown in economic growth can be expected over 2004–6, as the rate slips from 10% to 7%.

In 2004, the economy will steam ahead at a 10% rate

Although prospects for active reform seem pessimistic, ICPS is upgrading its forecast for economic growth in 2004 to 10%.
The continuing favorable situation on foreign markets will spur growth in sectors directly related to exports: industry (13%) and transport (12%). High industrial activity will also contribute to keeping growth rates very high in construction (20%). As personal consumption continues to grow at 12%, sales will grow at about 15%.

Strong economic trends and the economy's need for capital injections because of severely depreciated capital assets will help maintain a high level of investment activity. Thus, ICPS is revising its forecast for the growth rate of gross accumulations of capital assets upward, to 14%.

ICPS expects Budget spending to remain largely unaltered, at 28.5% of GDP. For the second year running, high growth in public consumption (12%) in the run-up to the presidential election will lead to higher spending in education (+6%) and healthcare (+5%).

Lower tax pressure will push Budget revenues down to 27% of GDP. At the moment, the Budget deficit can be relatively easily covered through foreign credits and privatization revenues.

Imports will now grow somewhat faster than exports, which should cause a further reduction in the trade balance. Meanwhile, substantial capital inflows in the form of FDI and money transfers from Ukrainians working abroad should allow the National Bank of Ukraine to steadily replenish its gold and hard currency reserves and maintain a stable exchange rate.

The 2004 Consumer Price Index should rise 6%. This year, a far better grain harvest compared to 2003 and the Government's efforts to curb inflation by preventing increased in industrial production costs to be passed along to the consumer should result in moderate price growth.

Participants of international banking conference say Ukraine's sovereign rating is underestimated

On 27-28 May 2004, Budapest hosted the 10th international conference on banking and sovereign risks in Central, Eastern European and CIS countries. Similar events bring banking experts and analysts together every half-year to discuss the financial and macroeconomic standing of countries in this region. For the third time, ICPS Senior Economist Andriy Blinov was invited to present an assessment of macroeconomic, socio-political and banking risks in Ukraine.

While discussing the sovereign ratings of their countries, participants emphasized that the investment ratings given Ukraine by the leading rating agencies seem to be somewhat lower that the country's real investment potential. Investors see this situation as a good opportunity to get involved in speculating on Ukrainian securities. Among the key reasons for the understatement of Ukraine's investment appeal the participants listed corruption, which is ubiquitous to all post-soviet countries, and a slow transition to international standards.

Presentation materials illustrating the ICPS view of Ukraine's economic situation, political environment and banking system can be found at: http://www.icps.com.ua/eng/library/show.html?5

GDP growth will slow down in 2005–6

A slight deterioration in world markets and a slowdown in the pace of growth of Ukraine's major trading partners will dampen economic growth in Ukraine during 2005–6 and stimulate the Government to take measures to develop domestic markets. This will be most apparent as reforms kick in the residential and public services sectors. ICPS economists expect economic growth rates to drop to 8% in 2005 and 7% in 2006.

Investment demand will remain unstable. The ICPS forecast is that the expansion of the domestic market will lead to high rates of investment in the light and food industries. At the same time, a worsening in the global situation will lead to reduced investments in export-oriented sectors, such as metals and metal products. This should also slightly slow the pace of gross fixed investment to 10% in 2006.

The key factor behind Ukraine's economic growth will be domestic demand. The growth of real individual consumption, though declining slightly, will still be 9% for the year.

Deteriorating conditions for foreign trade will reduce the current account balance to US $0.9 bn in 2006. This will lead to lower money supply levels and less pressure on prices, which should help the Government's anti-inflationary policy. At the same time, less administrative control over prices in 2005 should allow the level of inflation to rise slightly, to 7% by year-end.

Preparations for Ukraine's accession to the WTO will force the NBU to revise its current scheme of currency regulation. Given the country's declining current account balance, greater fluctuations in the UAH/USD exchange rate can be anticipated. In 2006, ICPS expects a renewal of moderate nominal devaluation of the hryvnia.

Table 1. Main indicators

Years	2003	2004	2005	2006
Indicators	(est.)		(forecast)	
GDP, billons UAH	264.2	315.3	357.5	405.5
Real GDP, apc*	9.4	10.0	8.0	7.0
Real industrial output, apc	15.8	13.0	9.0	8.0
Real agricultural output, apc	9.9	9.0	3.0	3.5
Real gross fixed investment, apc	15.8	14.0	14.0	10.0
Real consumption, apc	12.8	12.0	7.7	7.8
Consumer price index, apc	8.2	6.0	7.0	4.5
Real wages, aapc**	24.0	12.0	10.0	10.0
Unemployment rate (ILO methodology), %	9.1	9.0	8.8	8.8
Exports of goods&services, apc	24.0	12.7	5.0	4.0
Imports of goods&services, apc	28.7	14.5	6.0	7.0
Current account balance, % GDP	5.8	4.4	3.2	1.2
Budget balance, % GDP	-0.2	-1.5	-0.5	-1.0
Net FDI, millions USD	1,411	1,600	1,800	2,000
Official exchange rate (average annual), UAH/USD	5.33	5.33	5.32	5.36

** apc = annual percentage change* *** aapc = average annual percentage change*

Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by Quarterly Predictions

What's behind Ukraine's economic growth

According to ICPS, Ukraine's economy has heated up for a number of reasons:

- **Widespread acceptance of new market conditions.** Ukrainians are participating more and more in the market distribution of labor, which has contributed to lower unemployment rates and growing positive expectations of economic development.
- **A favorable situation on world commodity markets.** This applies first of all to the main Ukrainian export products, metals and chemicals: prices for these have gone up on average 30-50% over the past three years.
- **Enlivened privatization.** For the first time in recent years, the State Property Fund fulfilled the State Budget plan for privatization revenues, raising UAH 2.15 bn in 2003. The interests of big business, which wants to maximize benefits from its support to the ruling coalition, and the Government, which is keen to increase the social benefits in the run-up to the presidential election, made it possible, through the mechanism of privatization, to stimulate both domestic investment and consumption.
- **Rising household incomes.** Despite moderate growth rates for real household incomes, the Consumer Confidence Index and Index of Propensity to Consume have steadily improved.
- **Financial stability.** The UAH/USD exchange rate has remained unusually stable over the last two years. This means that the competitiveness of exports based has been steadily rising as the real effective exchange rate has long been devaluating. Regardless of the unstable situation on some markets, the Consumer Price Index has not passed the 10% mark in the past three years. Finally, since 2000, the Government has not allowed the Budget deficit to exceed 1% of GDP.

Forecast risks

The key risk to this forecast for Ukraine's economic development in 2004–6 is the possibility of sudden changes in global markets, especially for metals and chemicals. Unexpected fluctuations could be due to both increasing and declining prices over the period.

Other risks to the forecast are:

- a radicalized political situation on the eves of the presidential (2004) and the VR (2006) elections;
- higher-than-expected reductions in 2004 Budget revenues if individuals fail to leave the shadow economy as anticipated after reduced tax pressures;
- high inflationary expectations related to prices controls for some goods, especially bread and energy resources;
- worsening liquidity among banks due to a steep rise bad loans;
- the establishment of an FTA within the Common Economic Area;
- an underassessment of the impacts of EU expansion;
- the failure of Ukraine to accede to the WTO in 2005.

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